Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, June 14, 2001
"Analyzing the analysts: Are investors getting unbiased research from Wall Street"

To the question raised on a recent magazine cover - "Can we ever trust Wall Street Again?" - the simple answer is: we must. That is, we must find a way. It's not a choice. America's prosperity, as always, is intrinsically bound to the influx of capital investments that fuel business expansion, job growth, and technological advancement.

To the extent that America's faith has been temporarily shaken by the recent market downturn, our first goal here today is to begin a process of rebuilding confidence in the market. Not only to help reaffirm the American people's faith in the fairness of the market, but to earn their trust.

As a free-market conservative, I am the last person interested in government putting the market on trial or contributing unnecessary barriers against a market recovery that keeps expanding opportunities for all Americans. However, the foundation of the free-market system is the free-flow of straightforward, unbiased information. This subcommittee has a responsibility to safeguard this principle. And I must say I am deeply troubled by evidence of Wall Street's erosion of the bedrock of ethical conduct.

It's a new and continually changing market. Since 1995, online trading has resulted in enormous growth of investment by working families - some 800,000 trades a day by typical investors with $60,000 incomes and net worth of less than $50,000. These small, individual investors rely on what they believe to be objective, professional advice from sophisticated analysts.

Message to Wall Street: these small investors are the future of the market. They deserve fair treatment. Folks who work hard to pay the house note, taxes, and the grocery bill don't have the funds to speculatively gamble.

Over the last few years Wall Street's insiders have whispered knowingly about a kind of "grade inflation" and "coded language" in analyst recommendations, issued with a self-serving bias to solicit a client or to earn enhanced fees. A goal of this hearing is also to begin speaking openly about the unspoken, and to inform the public. I'm amazed to have learned just yesterday that "strong buy" really doesn't mean "buy" but actually means "outperform." Makes you wonder what an "outperform" recommendation really means. I am concerned about not only the potential for significant losses by the unwary, misinformed individual investor, but also the possibility of overall market volatility when a "rational" view returns.

Today we inquire into disturbing media and academic reports about blatant and pervasive conflicts-of-interest compromising the integrity of current market practices. In fact, I will now enter into the record a Harvard and Wharton Business School study entitled “The Relationship Between Analysts’ Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings.”

I now quote from the conclusion of that study:

> “Our evidence suggests that the coexistence of brokerage services and underwriting services in the same institution leads sell-side analysts to compromise their responsibility to brokerage clients in order to attract underwriting business. Investment banks claim to have ‘Chinese Walls’ to prevent such conflicts of interest. Our evidence raises questions about the reliability of the ‘Chinese Walls.’ We document that analysts affiliated with the lead underwriter of an offering tend to issue more overly optimistic growth forecasts than unaffiliated analysts. Furthermore, the magnitude of the affiliated analysts’ growth forecast is positively related to the fee basis paid to the lead underwriter. Finally, equity offerings covered only by affiliated analysts experience the greatest post-offering underperformance, suggesting that these offerings are the most overpriced.”

Let me say this in my own way. Maybe there hasn’t been complete erosion in the Chinese Walls that traditionally shielded analysts from investment banking interests. Or maybe somebody’s just been handing out a whole lot of Chinese Ladders for people to climb back and forth as they please.

A market bubble that bursts is a time when some people look for someone to blame. Instead, I believe it should be an opportunity for all concerned to step back, take a deep breath, and re-examine their own accountability to make sure it doesn’t happen again. All parties have to share responsibility.

If today we focus our gaze on analysts’ conflict of interest, then at some point we will focus on the investment banks that encourage the conflict of interest, the institutional investors who expect it, and even the financial press that glosses it over and thereby amplifies its harmful consequences.

Let me say a word about the financial media, whose impact in this may be greater than we now realize. It is irresponsible reporting to quote unquestioningly irresponsible analysts and place them on magazine covers and turn them into rock stars.

Consequently, while I appreciate the “Best Practices” proposals put forward by the industry, I am not convinced they go far enough to insure accountability and enforcement. I take the very drafting of them as a positive sign that the industry admits and accepts that problems exist. But I’m naturally skeptical of a document that contains a disclaimer, which, to me, essentially says “We promise to be honest … unless of course circumstances warrant that we can’t be.”

Today is not the end of our discussion but a beginning. In the next few months we will assess these recommendations and converse with regulators. At the end of the process, the committee will either help develop a “Best Practices” standard, make recommendations to regulators, or propose legislation if warranted.

Particularly for the sake of the growing number of $200-at-time investors planning for a family, an education, or a secure retirement, it is far more important to do this carefully than it is to do this quickly. And we will continue this effort until we reach an appropriate conclusion.

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